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Pension **ANALYST**

Important Information   Plan Administration and Operation   February 2006

IRS Issues Final Rules for Roth 401(k) Accounts

WHO'S AFFECTED   This information applies to 401(k) plans, including multiemployer plans, governmental plans, and nonelecting church plans. This information does not apply to ERISA 403(b) plans or non-ERISA 403(b) arrangements.

BACKGROUND AND SUMMARY   The Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) authorized the establishment of Roth 401(k) accounts beginning January 1, 2006.   As discussed in our April 2005 *Washington Update*, the IRS issued proposed Roth 401(k) regulations on March 1, 2005. On December 30, 2005, the IRS finalized these rules with a few clarifications. However, certain issues remain unresolved.

This publication summarizes the final rules and points out where further guidance is needed. In addition, this publication identifies the steps that plan sponsors may need to take to implement the Roth 401(k) feature, as well as how Prudential Retirement can assist plan sponsors in this process.

It is important to note that these final rules only apply to Roth 401(k) plans. However, shortly before this issue of the *Pension Analyst* was published, the IRS issued proposed Roth 403(b) regulations, along with proposed rules regarding taxation and recordkeeping issues for Roth 401(k) and Roth 403(b) accounts. Prudential Retirement is currently analyzing these proposed rules, which will be discussed in an upcoming *Pension Analyst*.

ACTION AND NEXT STEPS   The final rules generally apply to plan years beginning on or after January 1, 2006. Before adding a Roth 401(k) feature, plan sponsors may need to take certain steps to ensure payroll systems are in order and that participants have received adequate communication and educational materials. Please contact your Prudential Retirement representative if you are interested in adding the Roth 401(k) feature to your plan.

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Overview of Designated Roth Contributions

The final rules provide that plans may allow an employee who makes elective deferral contributions to irrevocably designate some or all of their future elective deferral contributions as Roth contributions. Unlike "traditional" deferral contributions, which are not subject to federal income tax when they are contributed to the plan, designated Roth contributions will be included in the employee's current taxable income. These contributions, along with earnings, are not taxable when qualified distributions are made at a later date.

In order to provide for designated Roth contributions, a plan must also offer pre-tax elective contributions. Therefore, a plan is not permitted to offer only the Roth feature.

Separate Accounting Requirement

Plans must recordkeep Roth 401(k) contributions and related earnings in a separate account (money source). Forfeitures may not be allocated to the designated Roth account and no contributions other than Roth contributions or rollovers from another Roth 401(k) plan may be made to the Roth account. The requirement to separately account for Roth 401(k) contributions applies at the time the designated Roth contribution is made to the plan and continues to apply until the designated Roth account is completely distributed. As a result, a participant cannot make a regular pre-tax contribution, and later have it "recharacterized" as a Roth contribution.

Elective Deferral Rules

Designated Roth contributions must satisfy the rules that apply to regular elective deferral contributions. Therefore, Roth contributions must be fully vested and subject to the same distribution restrictions that apply to pre-tax elective deferral contributions. A single deferral limit ($15,000 in 2006) and catch-up limit ($5,000 in 2006) apply to the combined total of an employee's Roth 401(k) contributions and regular pre-tax contributions. Roth 401(k) contributions are subject to the minimum required distributions rules in the same manner as elective deferral contributions, even though Roth IRA accounts are not subject to those rules. Roth contributions may serve as the basis for participant loans. In addition, Roth 401(k) contributions will need to be included in the actual deferral percentage test (ADP test) in the same manner as pre-tax elective deferral contributions.

As with pre-tax elective deferral contributions, a plan must provide employees with an opportunity to make or change their Roth 401(k) deferral elections at least once during each plan year. In addition, a plan may use automatic enrollment for Roth 401(k) contributions. If a plan that uses automatic enrollment allows Roth 401(k) contributions, the plan must clearly specify whether the default contributions will be pre-tax elective deferral contributions or designated Roth contributions.

Direct Rollover

A plan is not required to allow a direct rollover if the amount to be distributed for the year is reasonably expected to total less than $200. These final rules allow a plan to treat the Roth 401(k) contributions and all other contributions made to the plan as two separate plans for purposes of determining whether the $200 threshold has been met. Therefore, if a participant takes a distribution due to termination of employment with an account balance of $3,150 ($3,000 consisting of pre-tax and employer matching contributions and $150 Roth 401(k) contributions), the plan would not be required to offer a direct rollover of the Roth portion.

Currently, Prudential does not apply this $200 exception when making distributions and offers rollovers of all eligible rollover distributions, regardless of amount.

It is not clear whether Roth balances can be treated separately for purposes of applying the automatic rollover rules. Additional IRS guidance is expected on this topic.

However, these final rules do indicate that amounts in Roth 401(k) accounts may only be rolled over to a Roth IRA or to another 401(k) plan that accepts Roth contributions.

Corrective Distributions

A plan may allow highly compensated employees (HCEs) with pre-tax elective contributions and designated Roth contributions to elect whether excess contributions (from a failed ADP test) are to be corrected first from pre-tax elective deferrals or Roth contributions. However, a plan is not required to provide this election, and instead may provide for a correction method without permitting an HCE to make an election.

To the extent corrective distributions resulting from a failed ADP test represent Roth contributions, the excess contributions are not taxable. However, the earnings on those contributions are taxable.

Plan Amendment Issues

The IRS has informally stated that a model amendment for Roth 401(k) contributions will be provided, however, the final rules did not address such model amendment. We will keep you informed in the event the IRS issues a model amendment. However, under EGTRRA, a plan sponsor has until the end of the plan year in which the Roth 401(k) feature is effective to adopt an amendment. If you are interested in adding the Roth 401(k) feature and Prudential Retirement provides document services for your plan, we will work with you to amend the plan after the IRS issues a model amendment.

The final rules did indicate that there are aspects of Roth 401(k) contributions that should be included in an amendment that may not be addressed in the regulations. For example, the extent to which an HCE can choose whether his or her ADP corrective distribution will be made from a designated Roth account or other accounts should be included in the plan document. Additionally, for plans with automatic enrollment, the extent to which the default contributions will be pre-tax contributions or designated Roth 401(k) contributions should be included in the plan document.

Further Guidance

Although the final rules do clarify some of the proposed rules, they did not provide guidance on many of the issues involving the taxation of distributions of Roth contributions. However, the taxation issues have now been addressed in proposed regulations, just issued by the IRS. Prudential Retirement is currently analyzing these rules, which will be discussed in an upcoming *Pension Analyst*.

Additionally, the ability to make Roth contributions is scheduled to "sunset" in 2010, unless Congress makes the EGTRRA provisions permanent. If the ability to make Roth contributions is allowed to "sunset," further guidance will be needed.

Effective Date

These rules generally apply to plan years beginning on or after January 1, 2006. However, certain plans, (i.e., non-calendar year plans or plans that are established pursuant to a collective bargaining agreement that has a delayed effective date for the section 401(k) rules), may apply these rules before the effective date of the final section 401(k) rules, even if the plan does not otherwise apply the final 401(k) and 401(m) rules earlier. For example, a plan with a plan year beginning July 1 may add the Roth 401(k) feature as of January 1, 2006, but will need to amend the plan to reflect these provisions by June 30, 2006.

Prudential will offer comprehensive Roth 401(k) services to our clients. With the publication of final regulations delayed until December 30, 2005, and the further delay of guidance regarding taxation issues, we are committed to making the Roth 401(k) feature available later in 2006. If you are interested in adding the Roth 401(k) feature to your plan, please contact your Prudential Retirement representative.

Next Steps

Employers may need to take the following steps to add a Roth 401(k) feature:

- Make necessary changes to payroll systems in order to:
  - Properly withhold for Roth contributions and Roth catch-up contributions;
  - Include Roth contributions and Roth catch-up contributions in Forms W2;
  - Calculate matching contributions appropriately;
  - Include Roth amounts in monitoring the deferral limit and catch-up limit ($15,000 and $5,000 respectively, for 2006);
  - Include Roth amounts in ADP testing data; and
  - Make changes to payroll/contribution data files for Roth contributions.
- For plans with automatic rollovers for mandatory distributions exceeding $1,000, establish a Roth IRA provider for automatic rollovers of Roth balances.
- Amend the plan, generally by the end of the plan year during which the feature is added, and communicate the feature to plan participants and beneficiaries through a revised Summary Plan Description (SPD) or Summary of Material Modifications (SMM).
- Provide participants with educational materials. Prudential has already begun developing tools and materials to assist you, including an interactive online calculator. For more information regarding these materials, please contact your Prudential Retirement representative.

Pension Analyst by Prudential Retirement
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